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SUBJECT: IMF MISSION BEGINS TALKS AMID GROWING MARKET ANGST

REF: ANKARA 4180

1. (SBU) Summary: An IMF team began talks in Ankara this afternoon amid growing market nervousness over U.S.-Turkish relations and continued delays in meeting the conditions for the Fifth Review under the IMF-backed program. Treasury U/S Canakci told us the government still is shooting for an IMF Board Review by the end of the month, but he admitted the GOT still has much work to do to address the fiscal gap and pass legislation to restructure Turkey's various social security funds. Canakci also confirmed that the government will shortly replace all three of his deputies; he insisted that the replacements would reassure the markets. End Summary.

2. (SBU) An IMF mission began talks with GOT officials this afternoon on the remaining steps to be taken for the Fifth Review under the IMF-backed economic reform program. The talks began as markets continued to slide, with bond yields on the benchmark t-bill rising to 56 percent and the lira weakening to TL 1.42 million/dollar. Market analysts attributed the decline to growing nervousness over U.S.-Turkish relations (in the wake of the July 4 U.S. detention of Turkish special forces personnel in Northern Iraq), delays in completion of the Fifth Review, and press reports that all three Treasury Deputy Undersecretaries would be sacked.

3. (SBU) Treasury U/S Canakci told us this morning that the GOT still hopes to complete the review this month. He noted that Parliament had already approved legislation restructuring the state unemployment agency (Is-Kur), and that the Budget Committee is now debating legislation to restructure the Bag-Kur and SSK social security funds (press reports indicate the Committee approved the SSK legislation late today). Canakci said the government had given up on the idea of making these bills "fundamental laws," which would have put them on a legislative fast-track; however, the opposition CHP had agreed to work with the government to accelerate passage of both bills. The government also has been unable to reach agreement with the IMF on language about rescheduling social security arrears. Despite the GOT's best efforts, Fund staff continue to worry that the government has in mind a general amnesty or rescheduling, which would violate the terms of the last LOI. As a result, the government has left rescheduling language out of the legislation. (Note: Canakci confirmed that expectations of a social security amnesty has caused a decline in social security premium payments, especially to the Bag-Kur fund.)

4. (SBU) Canakci admitted that the government still had not agreed on all of the measures needed to close the fiscal gap that the previous IMF mission had identified. That gap, he said, was equal to 0.4 percent of GNP or about TL 1.05 quadrillion (\$750 million at today's exchange rate). The cabinet is now considering a decree to increase the Special Transaction Tax and an educational levy; if approved, this would reduce the gap by approximately TL 250 trillion. Treasury plans to cover the remaining TL 750 trillion gap via a combination of electricity price increases (TL 500 trillion) and other measures yet to be identified; however, the Energy Minister continues to oppose electricity price increases. In addition, the outcome of ongoing wage/salary negotiations with civil servants could add to the fiscal gap, though Canakci insisted the government would remain tough and limit the fiscal damage. (Note: IMF ResRep has previously told us the fiscal gap was slightly larger, at 0.5 percent of GNP, and also has pointed out that it may be revised, depending on the current mission's review of budget results through end-June.)

5. (SBU) On other structural conditions, Canakci acknowledged that the GOT was behind schedule on eliminating

redundant employees in state enterprises. It has eliminated 7400 redundant positions, against an end-June target of 9900.

He predicted that this process would accelerate as soon as the ongoing civil service wage negotiations conclude. On Turk Telekom, he echoed IMF ResRep in saying that the Fund had agreed that the GOT would work with the World Bank to name a privatization coordinator (already done) and put in place a full privatization strategy by Fall.

16. (SBU) Canakci also confirmed press reports that all three of his deputies would be replaced shortly. In fact, the document authorizing their removal is now with the Prime Minister for approval. Canakci said the government had not yet decided on replacements, but he insisted they would be well-qualified people who would inspire confidence in the markets. (Note: IMF ResRep told us last night that he understood one of the replacements would be a highly-regarded official from the State Planning Organization.)

17. (SBU) Finally, Canakci expressed optimism about economic trends, noting that growth was trending up while inflation was declining. If present trends continue, he said, Turkey could end the year with growth above five percent, inflation close to the 20 percent annual target, and a net public debt/GNP ratio at 74-75 percent, below the 77.2 percent year-end target. We responded that such a positive scenario was indeed possible, and suggested that vigorous, consistent implementation of the economic reform program could help ensure it. We noted that much of the projected decline in the debt/GNP ratio depended on the continued strength of the lira, and that real interest rates remained very high because investors remained unsure of the government's commitment to reform. Rapid movement by the government now to complete the Fifth Review and otherwise move the reform process forward would be of great benefit in the Fall, when investors will try to determine whether and how Turkey will meet its large 2004 debt obligations.

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